YOUR FUTURE, YOUR SUPER: QIC'S RESPONSE TO PROPOSED PERFORMANCE BENCHMARKING MECHANISMS

QIC strongly supports the primary purpose of the Your Future, Your Super reforms which aim to improve the accountability, transparency and performance of the nation's superannuation funds. We also acknowledge and welcome the level of engagement undertaken during the drafting of the proposed reforms.

Furthermore, we note our original concerns[1] relating to a proposed annual performance test – which would have compared superannuation trustees' unlisted funds' returns to passive listed indices – have been largely redressed in the current draft. **However, we continue to believe the fixed income indices are inappropriate for floating rate or low duration portfolios.**

We view the inclusion of the new unlisted benchmarks for real estate and infrastructure as favourable as it removes the bias to compare unlisted assets to an equity beta and in the case of infrastructure, to an inappropriate sector and geographic benchmark.

We recognise a key driver of the Government's benchmark choice is simplification but we continue to believe some degree of risk measurement would be ideal: without this, superannuation trustees are potentially incentivised to "risk up" asset class allocations, potentially putting member returns at risk.

Our summary thoughts on a selection of the indices are below.

Proposed indices	QIC Comments
Australian unlisted infrastructure: • MSCI Australia Quarterly Private Infrastructure Index **International unlisted infrastructure:** • MSCI Australia Quarterly Private Infrastructure Index	We support the unlisted nature of the index but have residual concerns with: 1. The depth of the index 2. The mix of core and core plus assets with no risk measure 3. The retrospective inclusion of new entrants' historical returns 4. The mix of hedged and unhedged returns We advocate for an industry working group to work with MSCI as well as propose an eight-year moving average of the unlisted index be used as a potentially temporary proxy in the absence of a timely data update.
Fixed interest: Australian Fixed Interest • Bloomberg Ausbond Composite 0+Yr Index International Fixed Interest • Bloomberg Barclays Global Aggregate Index (hedged to AUD) Australian Cash • Bloomberg Ausbond Bank Bill Index International Cash	We remain concerned fixed income products with little or no interest rate duration cannot be appropriately measured against benchmarks that have significant interest rate duration such as the benchmarks specified. We propose the cash benchmark be used for fixed income products as it has a floating rate benchmark and does not import interest rate duration risk into the assessment.

[1] See our position paper *Your Future, Your Super Comparative Benchmarks: Eroding Our Retirement Resilience and Economic Rebuild* for more details.

• Bloomberg Ausbond Bank Bill Index	
Australian unlisted real estate index: MSCI/Mercer Australia Core Wholesale Monthly Property Fund Index - Post Fee Total Return Performance	We support this index at the overall real estate allocation level, noting sub-sectors will outperform and underperform at varying points. We do note that the index measures core risk only and as this is not risk adjusted, funds can "outperform" their peers by directing allocation into core plus/value add, which incurs more risk to the portfolio.

We are also pleased to see that administration fees are now accounted for with performance benchmarking. This is more reflective of the end product to members and will help ensure there is no loading of management fees into administration fees. **However, we question whether it is sensible for trustees to carve up administration fees – which tend to be set at a fund level rather than an asset class level – into asset class returns. We applaud suggestions such as basing the administration fee on the median member fee for all APRA regulated superannuation products.**

1.1 Proposed benchmarking indices

1.1.1 Infrastructure

QIC is pleased to note the regulations now included unlisted infrastructure benchmarks. We recognise all indices have their flaws and highlight our following concerns with the use of the MSCI Australia Quarterly Private Infrastructure Fund Index:

- ***A thin index.*** The MSCI Index is currently[2] "thin" with approximately 10 infrastructure funds managed by six managers, displaying a lack of industry segmentation. As of March 2021, nearly two-thirds of the index portfolio was comprised of two sub-sectors: 38.61 per cent allocated to transport and 24.2 per cent to airports. This issue also leads to a significant volatility in the index historically when funds are added or deleted.
- ***A blend of risk tolerances with no risk measurement***. The MSCI Index is a blend of core and core plus funds. As there are no risk measures in the proposed Your Future, Your Super framework, core funds will be inappropriately judged against this index in the absence of any risk metric segmentation.
- ***A rewrite of history***. The proposed index allows for retrospective inclusion of historical returns for new index entrants which will lead to re-stating the historical index returns. We understand this is a function of the index currently having an "unfrozen" status, however we have been advised this could be revisited as the index's universe expands.
- ***A mix of hedged and unhedged data***. There is a lack of transparency in the proposed index as contributors report in AUD without specifying the distinction between those funds undertaking currency hedging and those funds remaining unhedged. Given the significant movement in key overseas currencies relative to the AUD over the past 12 months, the differential between hedged and unhedged returns has been material. This introduces a significant new risk into the framework which cannot be managed ex ante by trustees as, even with astute hedging, they don't have clarity on what they are needing to hedge to.

[2] As of 31 March, 2021

We appreciate that if the MSCI Index is chosen as the benchmark for the industry, it should garner more contributors which will expand its survey universe and over time this should help the index mature, overcoming our concerns about its granularity, sector concentrations, volatility and lack of industry diversity.

QIC advocates for an industry working group to work with MSCI to enhance reporting and segmentation (e.g. hedged vs unhedged) as the index matures.

QIC is also concerned about the reforms' missing data solution, which advises a switch back to the listed index if the data for the last quarter's data is not present within 28 days following end of the financial year for which the performance test is conducted. This catapults us back into our earlier concerns of mixing an equity beta into an unlisted asset class.

We would advocate against any reversion to listed indices in the event there is a data gap and propose an eight-year moving average of the Unlisted Infrastructure Index to be used as a potentially temporary proxy in the absence of a timely data update.

1.1.2 Fixed Interest

1.1.2.1 Australian and Global Fixed Interest Benchmarks for Duration Product

QIC endorses the proposed benchmarks for funds that have interest rate duration.

1.1.2.2 Benchmarks for fixed income with low or no interest rate duration

As discussed in our initial proposal, fixed income products with little or no interest rate duration cannot be appropriately measured against benchmarks that have significant interest rate duration such as the benchmarks specified. While this is a complete mismatch of risk types, it is actually a dangerous one under current market conditions. There is the possibility that the choice of performance benchmarks implicitly starts to guide asset allocation and moves trustees away from low duration product into assets with higher interest rate duration. This switch may not be in members' best interest as we are at the lows of the interest rate cycle and would expect rates to rise (and bond prices to fall) over the next market cycle.

While there are indices that are floating rate credit only, which may serve as a better proxy, we appreciate simplicity is a key goal in performance benchmark choice.

QIC proposes the cash benchmark be used for a fixed income product which has a floating rate benchmark as it does not import interest rate duration risk into the assessment.

1.1.2.3 Cash benchmark

The proposed cash benchmark for Australian and foreign cash is the Bloomberg Ausbond Bank Bill. This is a broadly used index for cash funds.

We recommend successor language is used to acknowledge the global transition away from LIBOR based benchmarks and advocate over time for the use of the RBA Cash Total Return Index.

1.1.3 Derivatives and FX

The draft regulation statement specifies the way in which portfolio holdings must be disclosed. These disclosures are extensive and provide for significant extra detail than could be reasonably be required in the interest of transparency.

We note that there is market sensitivity to the data on some of the instruments being disclosed, particularly around option strikes and maturities. Exchange rules provide for strikes and exposures disclosure, and this increased reporting requirement would have the impact of now linking trades with particular funds – potentially reducing their anonymity in the markets and adversely affecting future pricing.

We propose transparency requirements can be met by aggregating data without detailing Maturity or Option strike as this would compromise a fund's ability to manage that risk.

1.1.4 Real estate

As with infrastructure, QIC is also pleased with the inclusion of unlisted indices for this asset class. We further note Treasury has published the proposed index as MSCI/IPD Mercer IPD Australian Monthly Wholesale Property Fund Index rather than the correct **MSCI/Mercer Australia Core Wholesale Monthly Property Fund Index - Post Fee Total Return Performance**.

While we applaud the inclusion of this unlisted index for benchmarking unlisted real estate investments rather than a listed property trust investment, we do highlight its broad-based nature may fail to account for differing investment objectives and profiles across real estate sectors which can differ greatly. This erodes its appropriateness for benchmarking singular strategies or strategies dominated by one sector; and any superannuation fund pursuing direct investments.

The increasing sophistication of superannuation funds has seen an increased propensity for direct investments into real estate assets as opposed to unlisted pooled vehicles. Due to the lumpy and illiquid nature of these investments, it may be difficult for an investor's portfolio to align to the proposed index and subsequently meet the performance benchmark.

We appreciate that a basket of sub-indices is not meeting the Government's requirements of a simple measure but highlight the MSCI/Mercer core sector specific indices would provide a more accurate benchmark for more focused real estate strategies either through unlisted funds or direct investments

1.2 Concluding remarks

As one of Australia's leading fund managers, we appreciate the government incorporating unlisted benchmarks into these proposed reforms. We also appreciate the increased transparency that will be achieved. However, we do remain concerned about the unintended consequences of driving trustees into these benchmarks as an asset allocation, rather than simply measuring their performance relative to them. In particular:

1. QIC remains concerned about the potential consequences of **fixed income** benchmarks with long duration being relied on at what is potentially the bottom of the interest rate cycle
2. For **infrastructure**, we recognise the choice of index is difficult and the chosen index has shortcomings which we believe with QIC-involved industry engagement will help the index mature over time and alleviate some of these concerns
3. QIC also wishes to highlight our ongoing belief that **return measures** are only half the issue; and we would still request **risk-adjusted methodology** being incorporated over time.